

## APPENDIX

FOMC NOTES - PRF  
March 25, 1997

Mr. Chairman:

I will be referring to the package of color charts distributed at the table.

Since your last meeting, market expectations have shifted:

- Here in the U.S., the economy is perceived to be stronger and there are pronounced expectations for an increase in rates by the Committee;
- In Germany, there is a sense that the economy is less weak than previously feared, and lingering expectations for an ease in rates by the Bundesbank have been unwound;
- In Japan, despite the current pace of economic activity, the dominant presumption among market participants continues to be that the economy will slow in the months ahead.

Looking at the first page of charts, you can see that U.S. short-term forward rates have been moving higher since mid-February, punctuated by the Chairman's Humphrey-Hawkins testimony and the retail sales figures.

German forward rates rose more gradually, as data releases pointed toward a moderate recovery and increasing confidence in forecasts of 2 percent plus growth for the year.

Japanese forward rates rose off their very low levels toward the end of the period. This shift -- which was much more pronounced in the Euro-Yen futures contract -- may only reflect year-end noise or could reflect a more significant questioning of the entrenched assumption that the Japanese economy will slow.

At the top of the second page: you can see that U.S. and German long-term rates have been backing up.

Despite rising yields in most bond markets, Japanese 10-year rates declined during the period -- reaching a new historic low of 2.19 percent on March 17th -- but now just recently backed-up off these lows.

- Although there has been the strong presumption that the Japanese economy will slow in the months ahead, as a consequence of the increased consumption tax and decreased government outlays in the new fiscal year,

there is at least some possibility that -- as the authorities keep saying -- the forces of the autonomous recovery will be sustained.

- The recent strong data, coupled with the Bank of Japan's apparent willingness to let the call money rate drift up above the Discount Rate in recent days are putting at least something of a risk in the market that the economy may indeed sustain its momentum into the new fiscal year and that a BoJ rate increase might not be too far off.

- This morning the Bank of Japan, through inaction, left the market in surplus, but call is still trading above the ODR.

- Last summer, you may recall, it was widely assumed that the Bank of Japan would follow any increase in rates by the Federal Reserve.

- Thus, year-end, window-dressing demand for JGB's may be obscuring the risks of a rising rate environment that are creeping at the short-end.

At the bottom of the page, you can see that the dollar came off its highs against both the mark and the yen.

- The yen showed more of a direct reaction to Secretary Rubin's changed rhetoric and the G-7 statement, as the market braced itself for intervention. The expectation of heavy repatriation flows also helped strengthen the yen a bit. But these flows did not materialize -- at least to the extent feared -- and as this became apparent and as the threat of intervention faded, the yen has been gently weakening during March.

- Dollar-mark showed hardly any response to the G-7 statement. The moderation of the dollar's rise against the mark reflected the somewhat improved German outlook as well as the unwinding of short-mark positions into other European markets, as the probabilities of an on-time EMU declined.

- It is worth pausing to note the two-pronged nature of the markets' assessment: the German economy may be somewhat stronger than previously thought, but it does not -- at least at present -- appear to be strong

enough to enable Germany's fiscal performance to encourage much optimism that EMU can occur on target and on schedule.

Turning to the third page: you can see what I think are noteworthy differences in asset market behavior.

- In the top panel, you can see four U.S. equity indices: the Dow Jones Industrial Average, the S&P 500, the Russell 2000 and the NASDAQ composite and, for perspective, the German DAX and Japanese Nikkei -- all re-indexed to January 1st, as they traded through last Friday.
- While the Dow and the S&P 500 -- depicted in the darker green lines -- have retreated from the peaks they reached after your last meeting, they are still trading well above where they started the year.
- Other segments of the market, however, represented by the Russell 2000 and the NASDAQ, have lost all of the gains they registered in January and are now in negative territory on the year.

In the bottom panel you can see:

- Three indices of corporate debt, and Canadian 10-year government bonds, expressed in terms of the basis point changes in their spreads to comparable U.S. Treasury yields since the start of the year.

(In the box you can also see the absolute level of these spreads at the start of the year, at your last meeting, and last Friday.)

- It surprised me to see that these spreads all narrowed in March, at the very time that market participants were increasingly expecting a firming in policy by the Committee and Treasury yields were backing up.
  - To a great extent, the narrowing in these spreads reflects the back-up in Treasury yields and the resilience in corporate issues and the Canadian bond.
  - While some lag in the adjustment of corporate yields to Treasuries is not uncommon, the extent of their resilience is being noted in the markets.
- There are some indications that the brokerage houses are encouraging investors to move into corporate debt as a "safer" alternative to the stock market -- reaching for yield by placing a heavier weight on corporate debt.

- Such strategies are frequently linked to the widespread view that, if the Committee raises rates today, it is unlikely that this would begin a tightening sequence of more than 50 or 75 basis points.
- Thus, there are many who see the anticipated degree of tightening as being unlikely to induce a recession and, therefore, unlikely to erode significantly the profitability of major corporations or to trigger a deterioration in the quality of corporate credit.
- The divergent performance of the major stock indices and of the small cap indices could also reflect a defensive positioning on the part of investment managers, favoring the more-liquid, lower risk, blue chips.
  - Yesterday's simultaneous rally in the Dow and decline in the NASDAQ appears to be consistent with such a pattern.
- Also consistent with the pattern of fixed-income market trading, 10-year Canadian government bond spreads have rallied since the start of the year, and have been trading below the 10-year Treasury since your last meeting -- reversing their more typical spread over Treasuries.

Turning to domestic operations: We completed 6 billion in coupon purchases in five separate passes between February 14th and March 12th, addressing some of the building reserve needs.

- Spreading these purchases out over several weeks, and announcing the quantities purchased after the conclusion of each operation, has done as much as I had hoped to reduce the sometimes-disturbing impact of our outright purchases on the market.

On many days during the period, the funds market traded on the soft side.

- You can see this on page 4, where the top panel shows the daily range, and the bottom panel the standard deviation around the daily effective, from the start of the year. In between you can see the period average effective rates.
- The softness since the end of January appears to be a by-product of the high excess holdings banks acquired early in the maintenance periods since your last meeting, as we provided additional reserves to deal with heavy payment-flow days which happened to fall at the start of these periods.

- This soft tendency pretty much disappeared beginning with the March 17th corporate tax payment date a week ago Monday.
- On that date, the Treasury account came in 2 and half billion higher than our estimates, but the pressure on the funds market was minimal.
- On the following day, however, we had an impressive 6 billion dollar miss in the Treasury balance, as tax payments exceeded our forecasts. This miss left only 12.4 billion in operating balances -- a new record low, well surpassing the previous low of 15.3 billion.
- Only late in the day did this significant shortfall exert upward pressure on the market, bringing the funds rate up to a high of 10 percent and leading to adjustment borrowing at the window of about 1 billion.
- As we often observe, the impact of firm conditions on one day lingered, and the funds rate traded with a firm tone following these misses.
- In the last few days, the funds rates has come under some upward pressure from widespread expectations of an increase in rates at this meeting.

Looking forward, I would like to request that the Committee again approve an increase in our intermeeting leeway from 8 to 12 billion for the same reasons I mentioned at your last meeting.

- We have allowed needs to grow and we find ourselves comfortable working with these larger needs. But with another extended inter-meeting period of almost two months, the risks that the future will not conform to our forecasts could cause needs to grow larger yet.
- I think it likely that we would undertake a bill pass early in the period for between 4 and 6 billion and I would like the additional 6 billion in leeway to provide room for:
  - the possibility of additional outright operations to meet the large remaining needs;
  - the risks that needs grow even more than expected; and
  - the risk that

On a separate topic, members of the Committee have received copies of our annual reports on open market and foreign currency operations and I hope you have also received a copy of my memorandum.

As I mentioned, I would like to include in the public version of the Desk's annual report on open market operations the appendix which contains the detailed listing of the System's holdings of each issue of securities.

- I hope that doing this will help market participants better understand the publicly-available amounts of each issue and further remove any lingering mystery from our outright operations.
- I had been under the impression that this had never been done; however, Norm recalled that the Board's annual report had included a listing of coupon issues until 1981, but we have been unable to ascertain why this was discontinued.

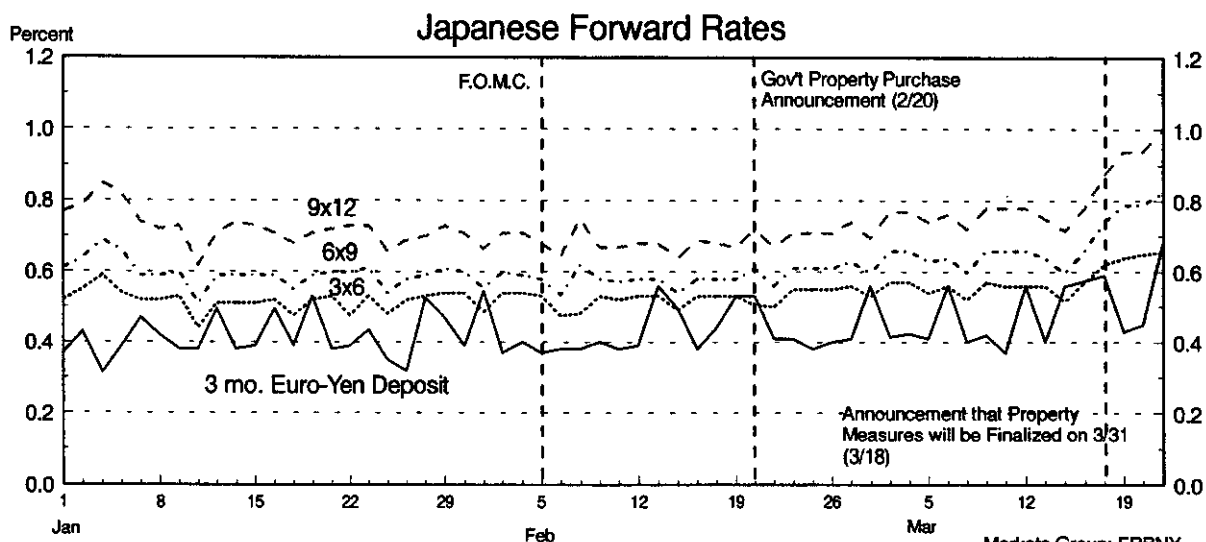
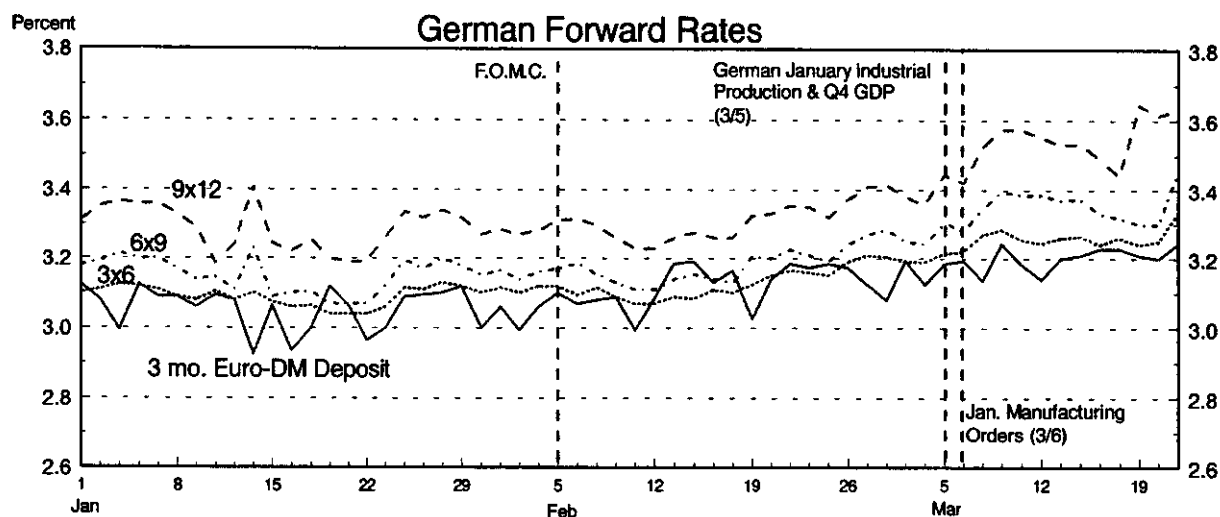
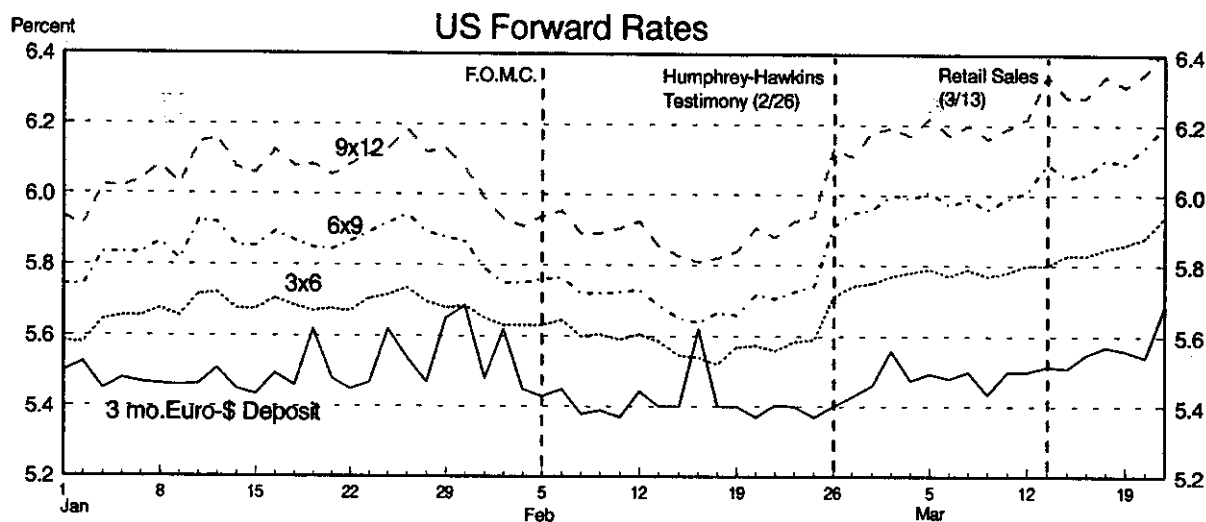
Mr. Chairman, we had no foreign exchange interventions during the period.

Thus, I will need two votes from the Committee:

- One for approval to increase the intermeeting leeway to 12 billion; and
- One to ratify the Desk's domestic operations.

I also hope the members of the Committee will not object to my proposal that we re-establish the tradition of publishing a end-of-year snap-shot of SOMA's securities holdings, despite a 16-year hiatus.

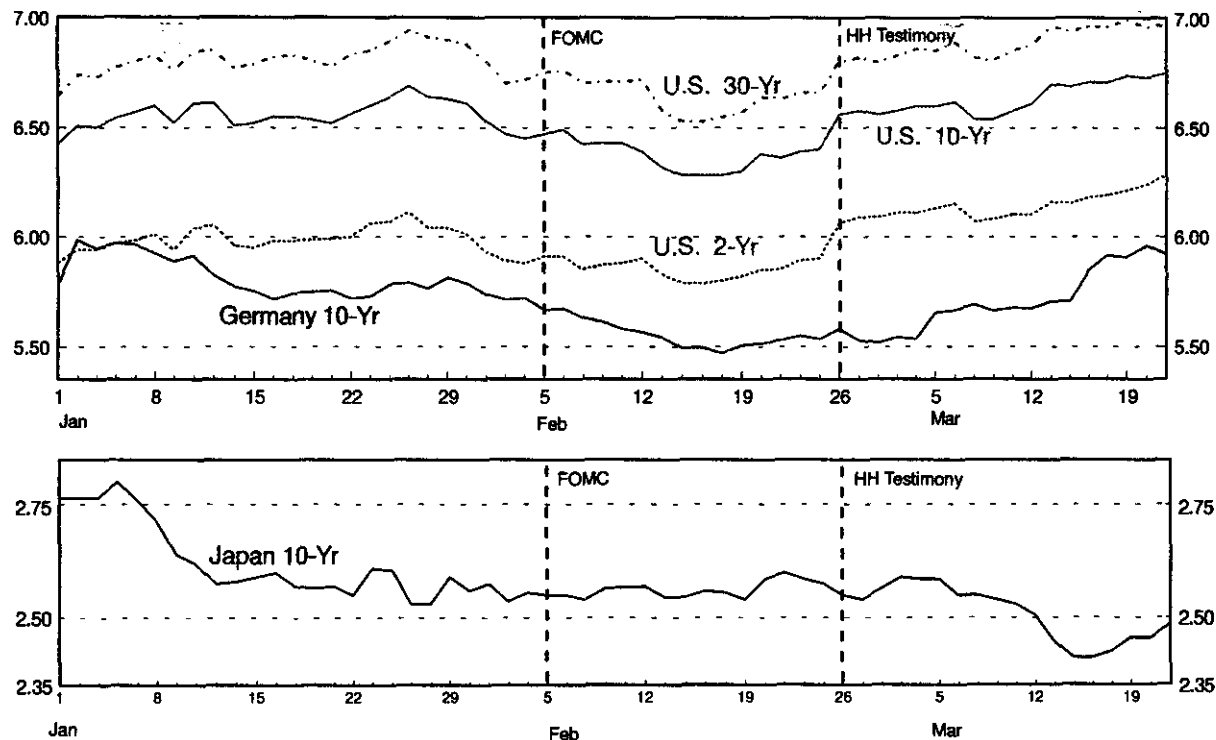
I would be happy to answer questions you may have about this proposal or any other aspect of my report.



Markets Group: FRBNY  
Gina Lukaszewicz

Percent

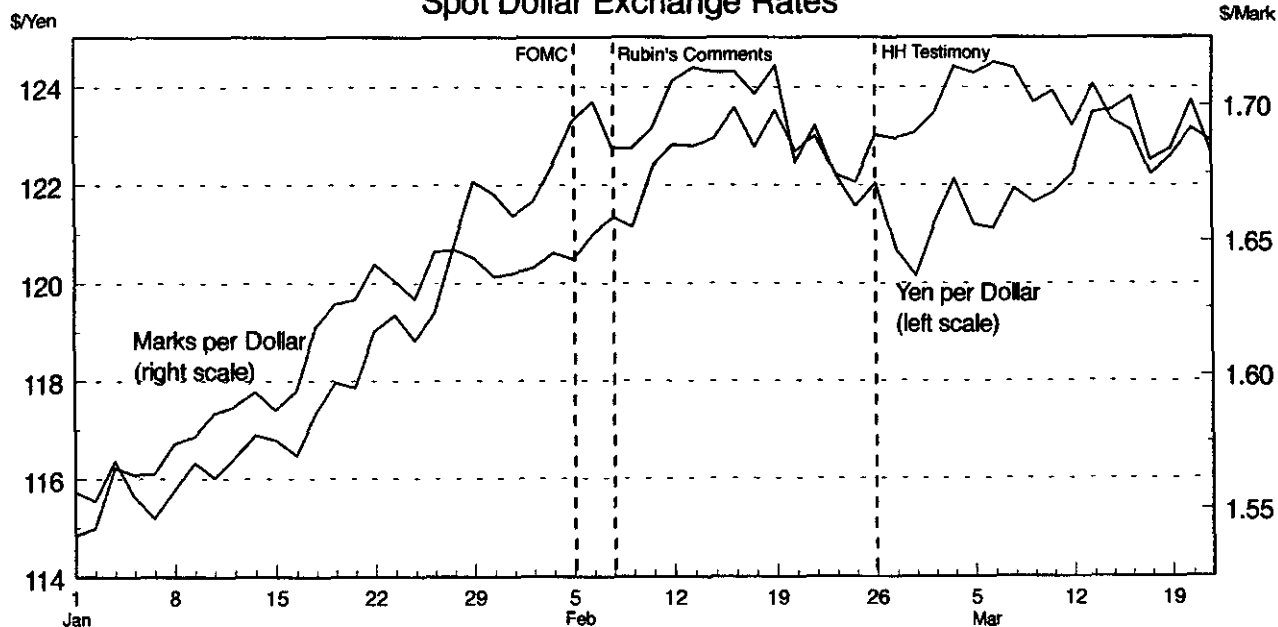
## G-3 Government Bond Yields\*



Source: Bloomberg

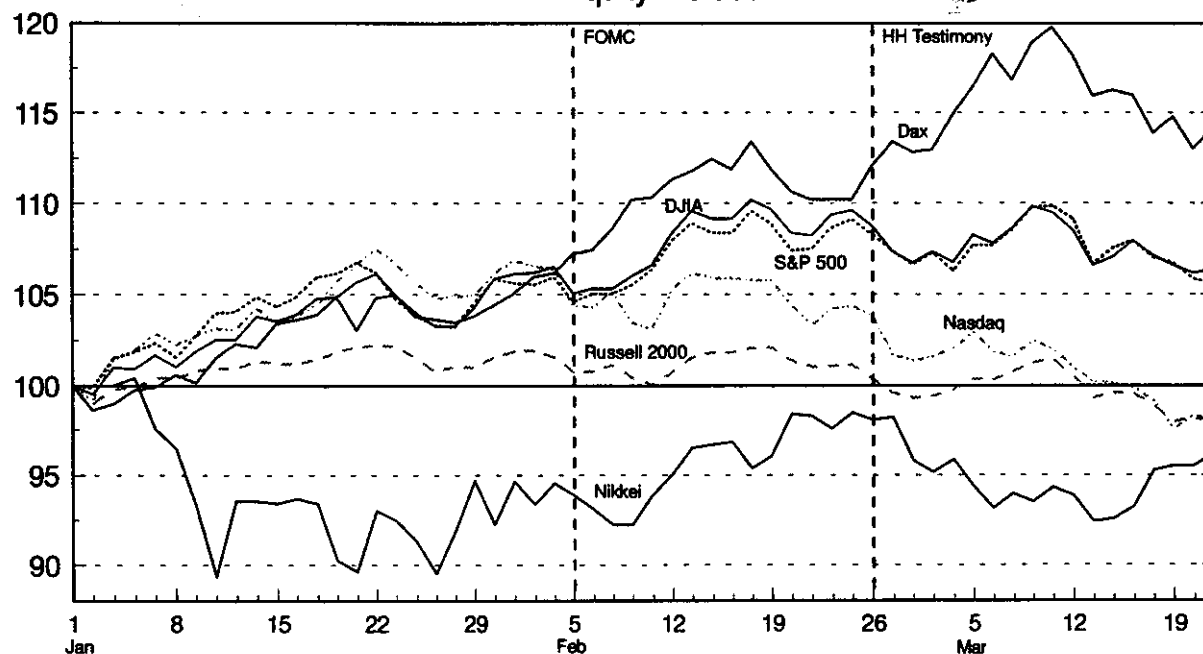
\*Data represents constant maturity yields. German yields are based on annual coupon payments.

## Spot Dollar Exchange Rates

Markets Group: FRBNY  
Gina Lukaszewicz

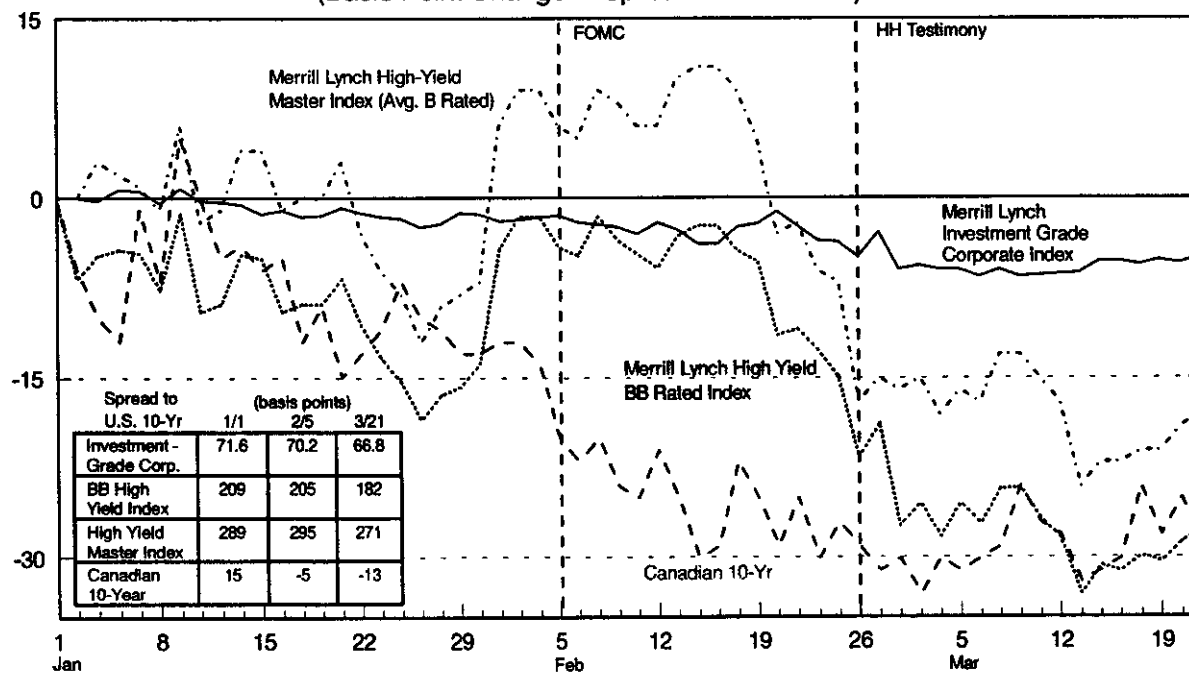
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### Equity Indices



### Selected Bond Yield Spreads Over Comparable U.S. Treasuries (Basis Point Change in Spread Since 1/1/97)

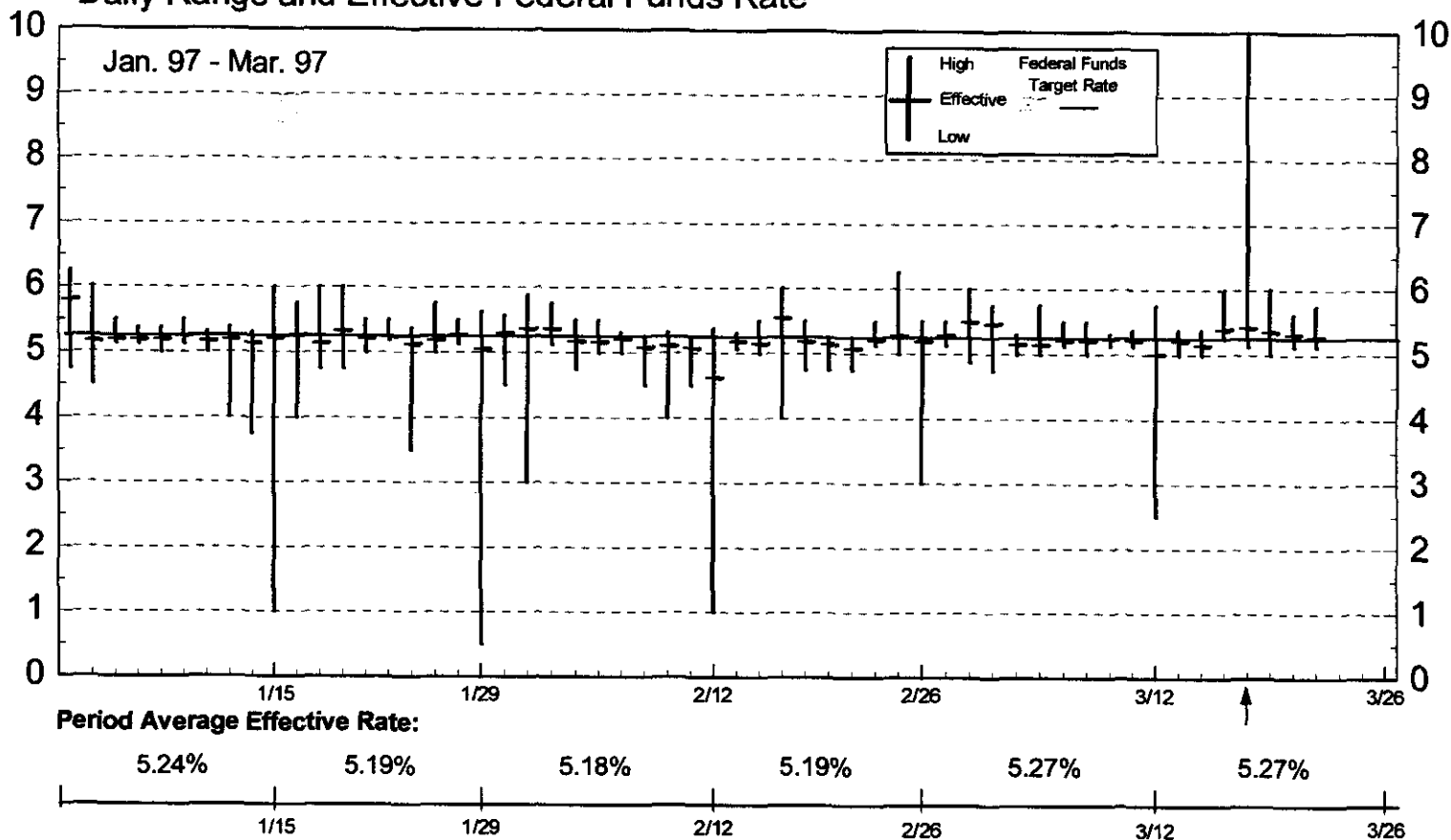
Basis Points



Markets Group: FRBNY  
Gina Lukaszewicz

# Federal Funds

## Daily Range and Effective Federal Funds Rate



## One Standard Deviation Around Effective Rate

